FLEURUS INVESTMENT ADVISORY

June 4, 2017

Overview

In May the S&P's 500 total return index rose by 1.41% and the Russell Mid-Cap index by .91%. Somewhat more surprisingly, the Small Cap Russell 2000 dropped by 2.03%. The Barclays US Bond Aggregate index was up .50% and the Bloomberg High Yield bond index by .81%.

International equity markets continued to out-perform their US counterparts. The EPAC BMI index of developed economies rose 3.38% due in part to a weakening USD and in part to a strong Eurozone market performance, particularly in France and Germany. Emerging markets had yet another robust month with the MSCI EM index up 2.80% and 16.59% Year To Date (YTD)

Below is the 3-month chart of the ETFs that track the equity performances of the French (blue line) and German (orange line) markets.

Since the first round of the French presidential elections in mid-April (vertical line), equities in France and Germany have gone up 14% and 11% respectively. Those markets have contributed mightily to the general out-performance of international developed markets overall.

In May, thanks to our international allocation, we outperformed our US benchmark. Our client portfolios rose between 1.10% and 1.58%. YTD these accounts are up between 6.60% and 8.65%. This compares to monthly and YTD performances of 1.12% and 5.89% respectively for a purely US-centric portfolio consisting of 50% SPY (ETF for the S&P's 500) and 50% BIV (US bond aggregate ETF proxy), over the same periods.

As a reminder, our allocation to equities currently varies from a minimum of 30% to a maximum of 60%, depending on the risk profile of each client.

Market developments

US equity markets were relatively quiet throughout the month except around May 17, when the firing of the FBI Director caused the S&P's 500 to drop 1.8%. That drop was short lived. The market was right back up within one or two days, propped up by generally good corporate first quarter earnings. All is not well though.

The performance of the small cap index, down 2.03% in May, does point to the inability of the Trump Administration to get traction on tax and regulatory reforms, and could be a harbinger of more serious and unpleasant surprises going forward. Below is the performance of the Russell 2000 (orange line) vs. that of the S&P's 500 (in blue) since the beginning of the year.

At the end of May the S&P's 500 total return index was up 8.66% YTD. The Russell 2000 was up 1.48% over the same period of time. The same type of under-performance afflicts all those sectors that sprinted ahead right after the US Presidential election, boosted by the hope of a new wave of tax cuts and deregulation (The "Trump Trade"). Since the beginning of the year, and as tax reform and deregulation appear to be more difficult to effect than to promulgate, sectors such as banking and industrials for example have stagnated, if not completely reversed their earlier gains.

All of this is happening at a time of extremely low market volatility (a measure of market risk). Over the past forty years, the volatility of the S&P's 500, as measured by the standard deviation of its 60-months moving average, has been as low as it currently is only twice: 1) from November 1995 to August 1997, a period of high annual equity returns that continued until March 2000 and, 2) from September 2007 to August 2008. I do not have to tell you what happened shortly after that period.

I am not exactly sure what to think of it all other than to be particularly cautious.

Tilts and allocations

In May we maintained our Eurozone equity market positions and continued to be well rewarded for that. French and German equities were up 4.5% and 5% respectively. That brings their YTD performance to 19% and 17% respectively. With portfolio allocations ranging from 10% to 15% for Eurozone and other international developed market equities, all customer portfolios benefitted from the continued rally.

The election of Emmanuel Macron has raised hopes for a better future for France and for Europe and pushed back against a rising tide of populism. That said this rally has as much to do with the return to better economic prospects for Europe. Improving economic fundamentals in the region have been materializing since last fall. They are likely to give this equity rally some more room to go. For now, we intend to maintain our allocations to the region.

Another area of over-performance in May was emerging markets. Some of our investments in that asset class are up 16% YTD, others 20%. This is a notoriously volatile sector that can inflict significant damage to a portfolio when markets reverse. Our portfolio allocations are sized in consequence, ranging from 3% to 8% on average and rarely approaching 10%.

Below is the five-year chart for ECON, the emerging market ETF that we use to gain exposure to the consumer class in emerging markets. Notice how volatile it is.

We are likely to reduce our exposure to the sector as ECON approaches the $28 mark, a level that, based on the graph above will be hard to break to the upside. That ETF is currently at $27.

Concluding remarks

High equity valuations in the US give me some concern. So does the poisonous political environment that makes sensible reform almost impossible to achieve. The eerily low current market volatility provides another cautionary signal.

It seems to me that pressure is building up again in the US financial system. Yet I can't see where or what the catalyst for a near-term market correction could be.

In this environment, international equities seem to offer a relatively better upside than US equities. Overall though, I remain rather weary. A US correction, when it occurs, will impact international markets too. I do not think that we are close to that point yet but we are getting closer to the next correction with each passing day!

Consequently, I will start clipping portfolios of their most volatile equities in the not too distant future. That will include technology stocks and emerging markets exposures in particular. After a YTD run-up of close to 20% in both sectors, some profit-taking seems warranted.

Please feel free to call me with any questions.

Best regards.